



# Use and misuse of unemployment benefits for early retirement

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## ABSTRACT

Unemployment insurance (*UI*) in some countries is one of the most widely used routes to early retirement. Accordingly, firms lay off elderly workers whose wages exceed their productivity. These workers then receive unemployment benefits until they enter formal retirement, even though they have effectively already exited the labor market. To persuade them into finding the deal acceptable, they quite often may also receive some additional compensation from their employers.

In this paper we consider three routes of transition from work to formal retirement that rely on *UI*: (i) standard unemployment compensation, (ii) public early retirement program yielding benefits higher than the unemployment compensation and (iii) unemployment compensation along with an income supplement provided by the former employer. The study examines under which conditions these three alternative practices can occur.

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## 1. Introduction

In a number of countries (including France, Italy, Germany, The Netherlands and Belgium) there is a fairly wide gap between statutory and effective retirement age. This gap undermines the financial viability of social security systems in a world of aging populations.<sup>1</sup> It can be explained by a number of provisions in various social protection programs. First the retirement system itself allows, and effectively often encourages, people to retire before they have reached the statutory age. Early retirement may imply a reduction in benefits. However, they usually remain quite generous and the adjustment is often less than the actual fair level. Several studies have shown that the structure of retirement benefits has a significant impact on inactivity rates among the 60–64 age group in OECD countries.<sup>2</sup> Second, there are professions where the official retirement age is lower than the standard age. Third, there are specific early retirement programs usually targeted at sectors experiencing economic difficulties. Finally, disability insurance and unemployment insurance are used in some countries to allow elderly workers to retire well ahead of the standard age, even though they are not suffering from a serious disability and not unable to find a job.

The Netherlands for instance is known for its disability insurance (*DI*) schemes which are not just used to provide insurance against the disability risk. Employers have often considered *DI* as a “decent” way to get rid of elderly workers whose productivity may be low compared to their wages. As a result, in 1999 the number of *DI* enrollments was as high as 10.4 per 1000 insured workers whereas in Germany and in the US it equaled 5.3 and 6.0 respectively.<sup>3</sup>

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<sup>1</sup> See on this Boldrin et al. (1999), Fenge and Pestieau (2006) and Herbertson and Orszag (2003).

<sup>2</sup> Gruber and Wise (1999) and Blondal and Scarpetta (1998a,b).

<sup>3</sup> Van Vuren and Van Vuren (2007).

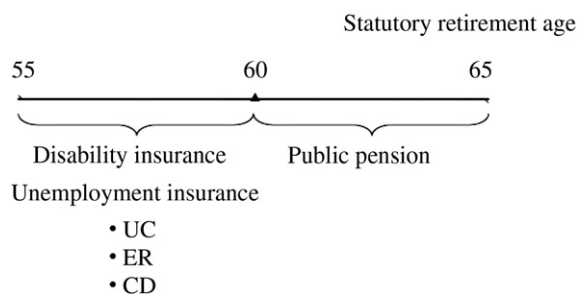


Fig. 1. Belgian exit roads (private sector).

In the neighboring country of Belgium, unemployment insurance (*UI*) is a popular avenue to early exit. A similar phenomenon can be observed in a number of other countries. Disability insurance tends to be generous. Unemployment insurance, on the other hand, is much less attractive. This may lead one to wonder why so many elderly workers take this exit route?

To better explain this phenomenon, let us take the example of the Belgian social security system for private sector salaried workers. In the window 60–64, workers can retire through the standard pension system with some penalty if their working career is not complete. In the window 55–59, they cannot draw any benefit from the pension system, but they can exit the labor force through unemployment insurance. There are effectively three ways to retire through UI. First, there is the UI scheme that people use when they do not have any other choice. They receive rather low benefits with just one advantage: they are no longer considered as actively seeking employment. We shall label this route *UC*. Second, they can exit through an early retirement scheme that offers both the unemployment benefit and extra compensation from the former employer with the consent of the government. These early retirement schemes are found in specific sectors, often for reasons of downsizing or restructuring. We shall denote this route *ER*. Third, workers can be persuaded by their employers to take unemployment and receive a side-payment making up for some of the difference between their salary and the unemployment benefit.<sup>4</sup> This package may appear to be a regular pension, but in fact is not. We shall label this scheme a Canada Dry (*CD*) pension, as it is known in Belgium.<sup>5</sup> Fig. 1 illustrates this situation.

These practices are highly questionable. Unemployment insurance is not intended to aid elderly workers who exit the labor force. Further, the extra compensation paid by employers effectively widens the use of UI for early retirement. The attitude of public authorities towards these practices is often ambiguous.

In this paper we consider the three different types of UI use and misuse, and how these policies can be rationalized as “optimal” policies within a specific setting and given “plausible” informational and institutional restrictions.<sup>6</sup> The three ways to retire via UI we consider are (i) a standard unemployment benefit scheme which exempts beneficiaries from job-search obligations (*UC*), (ii) an early retirement scheme that consists of unemployment benefits plus an allowance paid by the employer but approved by the government (*ER*), and (iii) “Canada Dry” arrangements (*CD*) that consist of unemployment benefits plus a lump-sum payment from the employer which is not formally approved by the government.

Belgium is undoubtedly the country where the three ways to retire early via the UI system are the best known.<sup>7</sup> What makes the two latter schemes attractive is that the top-up payments are taxed at a preferential rate and not in the same manner as regular earnings. Furthermore, under the three schemes individuals accumulate pension rights in the same way as active jobs seekers. There is evidence that both early retirement (*ER*) and unemployment insurance include *UC* and *CD* schemes. The confidential nature of the employee/employer relationship, unfortunately prevents any accurate accounting of use in relation to these two schemes. This lack of accountability is acknowledged by the [OECD \(2003\)](#).

Other OECD countries<sup>8</sup> have similar exit routes related to unemployment insurance. In France, the number of dismissals for personal reasons has increased over the last two decades.<sup>9</sup> These are often accompanied by severance compensation and viewed as more attractive than formal early retirement schemes. As to the importance of these dismissals, which look very much like the Belgian Canada Dry pensions, it can only be speculated. To mitigate its unemployment problems, Macedonia offers its elderly workers a package that includes unemployment compensation combined with a generous up-front payment that is either private

<sup>4</sup> This compensation exceeds the normal severance payment, if any.

<sup>5</sup> A “Canada Dry pension” looks like a pension, but is not a pension. This is reminiscent of an old commercial for Canada Dry ginger ale on the European continent, according to which it had the color of beer and the taste of beer, but it was not beer. Without being illegal, Canada Dry pensions can be viewed as an abuse or a misuse of UI. A good illustration of this is provided by the reaction to the application of stricter rules of eligibility for traditional early retirement schemes in Belgium. Following this reform, the Belgian unemployment agency (ONEM) reported in 2002 a tendency towards more exit of the labor force via the unemployment insurance which they impute to the Canada Dry pensions mechanisms. As a result, the share of expenditures of ONEM towards long term unemployment insurance for the old jumped from 14% in 1996 to 22% in 2002 whereas the share of expenditures towards the traditional early retirement schemes decreased from 22% in 1996 to 19% in 2002 (see [OECD, 2003](#)).

<sup>6</sup> There are of course various other factors that can explain (at least in part) why these policies are observed in practice. The simplest explanation would be just “bad design” but one can also think about various political economic reasons. Studying the policies from such a positive perspective would be an interesting complement to the more normative approach we take here.

<sup>7</sup> See [OCDE \(2005\)](#).

<sup>8</sup> See [OECD \(2003\)](#). For a good overview, see [Mirkin \(1987\)](#).

<sup>9</sup> [DARES \(2003\)](#).

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